The Hanging Curve

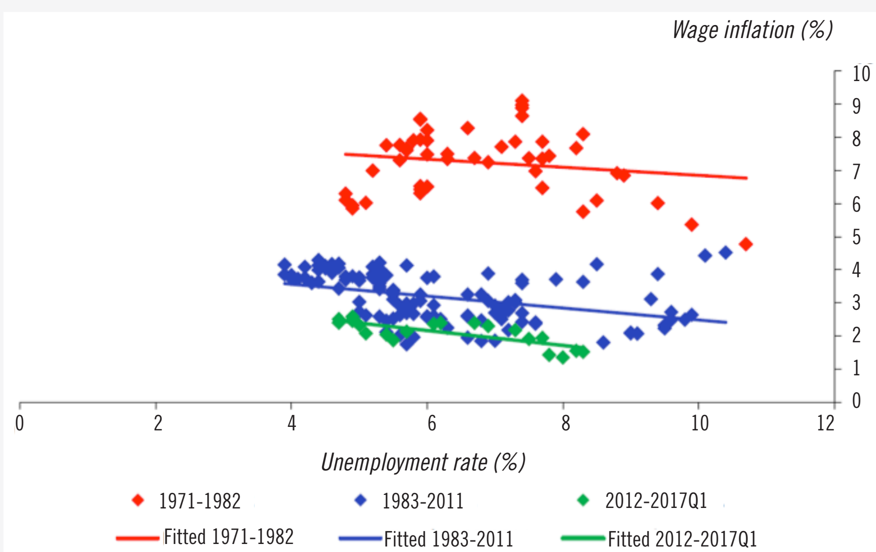
By Richard Thies

In baseball, there's nothing worse for a pitcher than throwing a hanging curve ball. The pitch doesn't have the intended movement and rather than snapping lower and out of the strike zone, it continues to move along in a straight line making for a very hittable pitch with typically unpleasant consequences for the pitcher. We see a similar curve hanging over global markets currently, one where policymakers are expecting and preparing for a snap to be forthcoming, but thus far it isn't happening. The Phillips Curve, the idea that tighter labor markets will drive higher inflation, remains at the core of Federal Reserve (Fed) decision-making despite the fact that the relationship between labor slack and inflation is tenuous. We think it's very important to keep in mind that this curve hangs over the Fed's thinking and thus remains a major market driver, whether or not the curve actually breaks as expected. The Fed's increasing focus on labor slack, over activity and inflation, is a risk for markets that hasn't yet materialized for a few key reasons.

Phillips Curveball

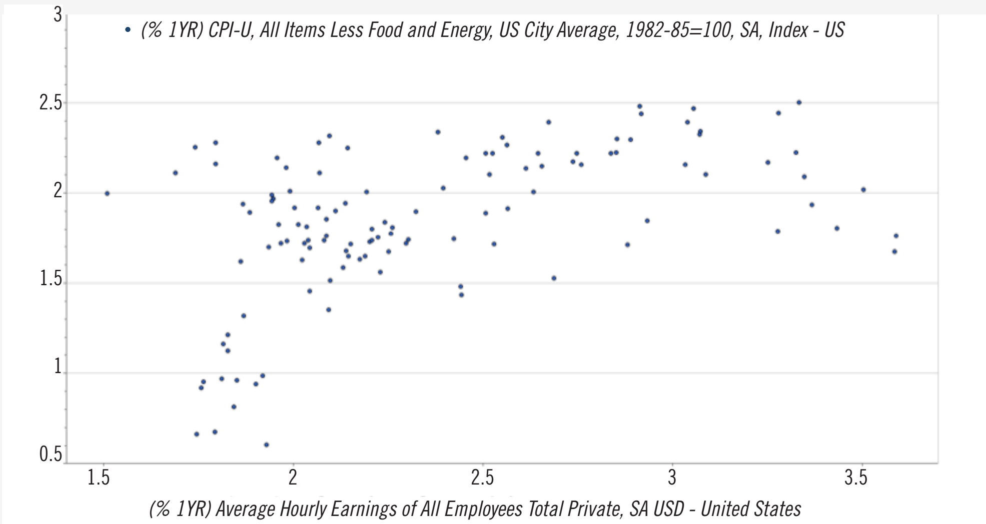
This idea that tighter labor markets drive inflation higher sounds pretty logical at first glance. As labor supply wanes, prices for labor move higher, pushing companies to raise prices, thus driving inflation higher across the economy, particularly in the more wage-sensitive services sectors. The problem though, is that it doesn't appear to be working that way. The Phillips Curve did a fine job explaining inflation for a long time and has been the basis for much of our understanding of how the economy works. In fact, during the 1970s and early 80s, this curve was the foundation for Fed policy and the academic work of the day (incidentally, the average year of college graduation for the current Fed voting members is 1979). However, it no longer explains much (Exhibit 1) and even if it did, wage growth also does a terrible job explaining the level of core inflation (Exhibit 2).

EXHIBIT 1: Unemployment and Wage Inflation



Sources: Thompson Reuters Datastream and Bank of England

EXHIBIT 2: The relationship between wage growth and overall core inflation is not as direct as many assume

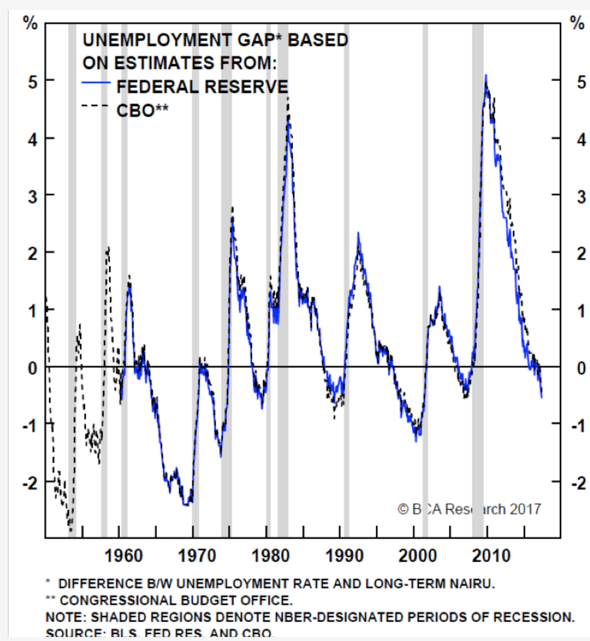


Source: Factset

We aren't the first people to point out the inadequacy of this understanding of the economy but we highlight it here because its role in policymaking is currently growing in importance. Arguably, the Fed's supposed dual-mandate of inflation and unemployment has really always been a single mandate to support the labor market. If that weren't the case, would the Fed have begun tightening policy a few years ago when their own long-term inflation forecasts were not reaching 2%? We are not criticizing previous decisions; just pointing out that in almost every recent action, the Fed is primarily focused on the labor market, not inflation. **Given how clearly labor supply is tightening (Exhibit 3), the Fed will continue to tighten regardless of realized inflation, meaning that real rates are going higher until actual inflation starts to pick up.** The track record for equity performance with higher real rates has not been very good in recent years.

This shift in all the recent Federal Reserve communiques and comments of Chair Janet Yellen has been very evident. While the conversation about all the fun secular stagnation-related topics continues (lower equilibrium rate, lower non-accelerating inflation rate of unemployment (NAIRU), remaining labor slack, too much savings and not enough investment, etc.), those topics are discussed as modifiers to an increasingly hawkish baseline view of the role of monetary policy. We agree that policy rates don't need to go too high to reach equilibrium now, **but that doesn't change the fact that this is the first time in almost a decade that the Fed doesn't clearly have our back as market participants.**

EXHIBIT 3:
The data supporting a view that labor slack has greatly diminished is very difficult to ignore at this stage



Source: BCA Research

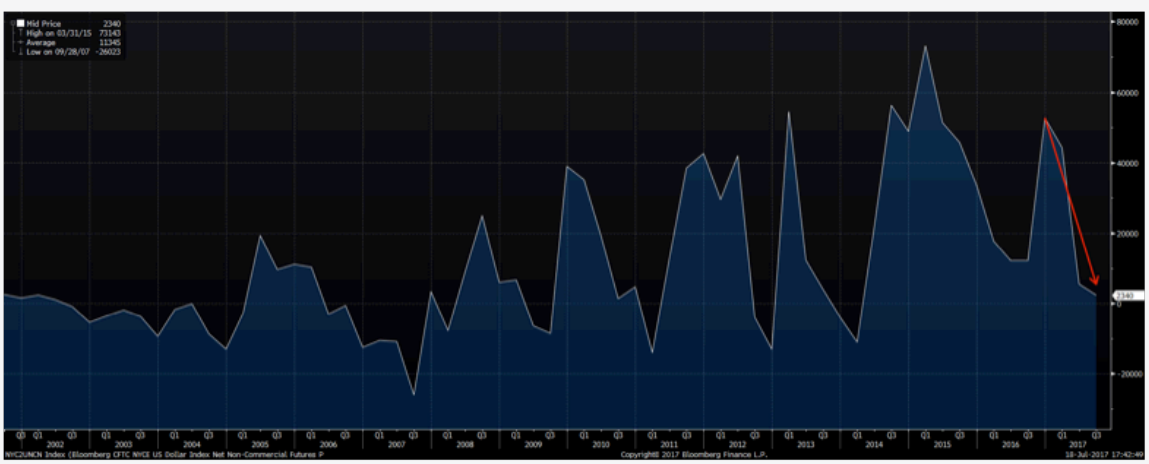
Why hasn't this change mattered?

Thus far, increasing real rates and a more hawkish Fed hasn't mattered much for markets for two reasons. First, the major channel through which a hawkish Fed hits asset markets isn't through higher rates themselves, but through the US dollar and the weakening dollar this year has been a tailwind for markets. The dollar hasn't strengthened because the increasingly hawkish rhetoric from the Fed has been matched and exceeded by other developed market central banks, thereby keeping rate differentials from widening further. In fact, given that the starting point for rates in places like Europe was so much lower than in the US, a hawkish tilt there has had a disproportionately large impact on rates markets and therefore, currencies. For reference, the Euro has strengthened much more than near-term rate differentials would have suggested. (Exhibit 4) The key reasons, aside from narrowing rate differentials, were the previously heavy positioning in the dollar (Exhibit 5) and better current growth momentum in Europe, which looks set to continue given a much stronger credit impulse than in the US.

Exhibit 4: The dollar (yellow) has strongly underperformed what would be implied by the difference between US and EU rates

Source: Bloomberg

Exhibit 5: One reason that the dollar has underperformed fundamentals this year is because of the near record high long positioning to start the year, which has now largely reversed



Source: Bloomberg

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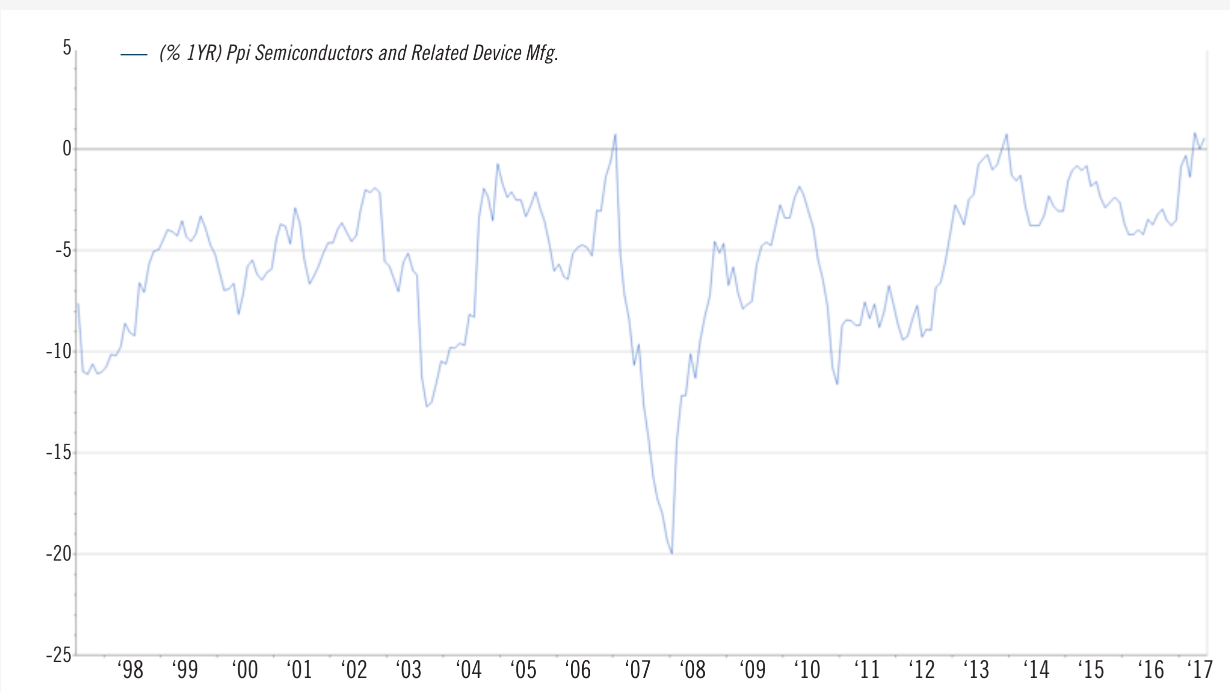
The second reason that this hawkish tilt and the increase in real rates hasn't mattered much for markets is because it has not been accompanied by any fear (we will spare you from including volatility index (VIX) and bond volatility charts here as we presume you've already seen plenty of those). The reason there's been no fear is because the mechanism that would make rates really shoot up, and engender that fear, is higher realized inflation. The market knows about the lack of labor slack and knows that if the Fed sees higher inflation, it will conclude it's behind the curve. Realized inflation has been extremely low this year but we think that reading the recent data as suggesting that the inflation threat is gone is wrong. Readings have been low from items that do not reflect underlying inflation trends, namely medical costs and shelter.

We are not inflation hawks by any stretch, but we believe inflation comes more from corporate pricing power than it does from wage growth and we see that pricing power increasing, not decreasing. We have long followed one commoditized industry, semiconductors, as a 'tell' on this subject. The semiconductors industry has a lot of capital and has seen a lot of investments over the years, enough to basically never let prices rise. If you've seen the behavior of the semiconductor stocks this year, you wouldn't be surprised to hear that even this tough industry is seeing some return of pricing power for the first time in many years, and it looks set to continue (Exhibit 6). This is just one example, but one that we see in many areas. One side effect of the weak business investment over recent years has to be higher prices at some point. We are closer than the Fed thinks to that point in many industries. Together with tighter labor conditions and slightly faster wage growth, the conditions are set for a narrative change on inflation in the second half of the year.

Exhibit 6: US semiconductor prices are going positive, reflecting one of many large industries seeing increasing pricing power in part due to lower investment



Source: Factset

Where do we go from here?

We highlight these dynamics because the markets so far this year have been powerfully driven by the weaker dollar, weaker sentiment toward cyclical activity and the slight fall in yields. We have seen relentless strength for everything that isn't tied to cyclicals, namely tech and internet stocks. This reversal in cyclical sentiment and the dollar's trend are the reasons growth and momentum have outperformed value so far this year (Exhibit 7), it's the reason why defensives and tech have done so well and it's a primary reason why non-US dollar investments, particularly those in emerging markets and Europe, have broadly beaten US counterparts. Given the backdrop described above, we see the conditions in place for this balance to change. Additionally, we see three specific reasons why the roadmap used to navigate this year, so far, will need to change.

Exhibit 7: The fading cyclical tailwinds so far this year have brought yields lower (white) and caused value to underperform (yellow) even more than historical relationships would suggest

Source: Bloomberg

1. While we are not structural dollar bulls, we see the dollar as having underperformed fundamentals so far this year and see the risk/reward shifting toward neutral to long dollar positions. The market is poorly positioned for such a reversal.

2. The cyclical weakness we were expecting this year is already fading. The key reason we were negative on cyclicals heading into the year was because of the slowdown in Chinese activity following major stimulus to the auto sector and infrastructure. The current evidence suggests that continued better exports, mostly thanks to Europe, is keeping activity levels stable here, with potential to increase. With financial conditions remaining very easy in emerging markets, cyclical activity should be given the benefit of the doubt and should prevent long-term yields from falling much more.

3. The market sentiment toward inflation will likely become less sanguine going forward and more focus will be on the Fed's new posturing.

It is our belief that the risk/reward favors a rotation in markets away from the themes that have worked so far this year. Even if you disagree with us and you don't believe that the fundamental backdrop for activity, inflation or the dollar will change much, the current trends have already overshot. As shown above, non-cyclicals have already underperformed what is justified, the dollar has already underperformed rate differentials and yields have fallen in spite of already-stabilizing activity levels. As a result, we believe that themes that have driven the market to date are unlikely to lead the market even higher.

About the Author

Richard Thies is a portfolio manager. In addition to his portfolio management responsibilities, he provides comprehensive macroeconomic analysis to the firm's investment management and research department, incorporating data releases, market expectations and government actions into forecasts for currencies, interest rates, sectors and market movements. He also conducts in-depth analyses of specific events and potential scenarios at the region, country and sector levels.

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